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Manager, Dissemination Branch
Information Management and Services Division
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552

Attention: Docket No. 2000-57

Dear Sirs and Madams:

We appreciate the opportunity to comment on the proposed revision of the regulations governing mutual to stock conversions and mutual holding company reorganizations. Our firm specializes in financial institutions law and has counseled hundreds of savings institutions concerning whether to preserve their mutuality or whether to change their corporate form through a mutual to stock conversion or a mutual holding company reorganization. As many of our senior partners served in senior staff positions at the Federal Home Loan Bank Board and were intimately involved in the promulgation of the original conversion regulations, we have a unique knowledge of the nuances and application of the conversion regulations and the policies underlying those regulations. In addition, our many years of experience in the thrift industry have given us a unique understanding of the mutual form of organization and its corporate governance and operation.

We believe that the OTS has done an excellent job in administering and refining the conversion process over the years to reflect changes in the thrift industry, the economy and the stock market. We welcome the OTS' efforts in reorganizing the conversion regulations and rewriting them in a plain language format to the extent that this facilitates the conversion process. The large number of successful conversions and the growth in assets controlled by institutions in the stock form are evidence of the success of the OTS' conversion program. The Federal Home Loan Bank Board noted the same in 1982: "The success of the conversion program is in large part attributable to the Board's Conversion Regulations, which strike an appropriate balance between the benefits to an institution of flexibility in structuring a reorganization and the rights of association members to participate in the reorganization process." 47 FR 19672. This observation is no less true 18 years later. Since 1982, the equity of OTS-regulated stock thrifts has increased steadily from \$7.4 billion to \$60.2 billion at the end of 1999. During this same period, assets of OTS-regulated stock thrifts have increased from $207 billion to $801 billion. For these reasons, we believe that the OTS should not make fundamental adjustments to the conversion process unless it establishes a compelling reason that is supported by empirical data and shows that it has fully analyzed the impact of the change. The portion of the proposal that creates new requirements for business plans will be a major impediment to the conversion process and marks a fundamental shift in the regulation of conversions. RP Financial, LC., a financial advisory firm experienced in valuations of mutual institutions, has submitted an analysis of the impact of the proposed business plan requirements, which shows how the proposed business plan requirements will prevent most mutual institutions from converting to stock form. We refer in this letter to the analysis submitted by RP Financial, LC. as the "RP Financial Analysis."

We have divided our comments into two sections. The first section consists of general comments on the revised regulations and responses to some of the specific invitations for comments. The second section of this letter consists of comments on specific sections of the revised regulations.

General comments

1. MHC Reorganizations.

We are pleased to see the proposed amendments to the mutual holding company regulations. The new policy towards dividend waivers and the proposed expansion of stock benefit plans are important steps in making the MHC structure more appealing. We note, however, that one problem inherent in the MHC structure has been its lack of investor acceptance. Enhancing the ability to provide stock-based benefits will make the MHC structure more desirable to persons affiliated with mutual institutions, but will not resolve the issues that have given investors reservations about the structure. The new policy towards dividend waivers is a positive step towards addressing this issue. In order to support this policy change and to reduce the likelihood of potential challenges by depositors, we encourage the OTS to make specific findings with respect to the effect of dividend dilution and the need for this policy change.

Although the goal of the proposal is to make the MHC structure more attractive, we are concerned that the proposal's business plan requirements may have the opposite effect. Many institutions use the MHC structure as an intermediate step to a full conversion. Because the ability to complete a second step conversion would be significantly curtailed by the proposed business plan requirements (as discussed in detail below), we are concerned that many institutions that would otherwise use the MHC structure would be reluctant to do so if they could not be assured of being able to complete a full conversion. Furthermore, we are concerned that the effect of the proposed business plan requirements would be to "land lock" existing MHCs in their current structure. This could further diminish the market acceptance of these companies to a significant degree because MHCs generally trade on the expected valuation in a second step conversion.

2. Business Plan Requirements.

We agree that a sound business plan is an important first step in the conversion process. However, we are concerned that by adopting a needs-based approach to permitting conversions the proposed regulations will stifle the creation of capital for the thrift industry. The RP Financial Analysis shows that fewer than 20% of thrifts that converted since 1989 achieved a return on equity of 10% or more in the three years following conversion. This statistic reflects the effects of stock repurchases and other capital management tools, which under the proposed regulations could not be considered in the business plan. If the effect of stock repurchases and special dividends were backed out of the analysis, the number of thrifts that would have achieved a 10% ROE within three years of converting to stock form would be significantly lower than 20%. Based on the historic performance of recently converted thrifts, the RP Financial Analysis shows that the proposed business plan requirements will effectively preclude most conversions. Although the proposed business plan requirements have not been advertised as such, they represent a virtual moratorium on conversions.

The proposed business plan requirements would mark a fundamental change in the regulation of conversions. There has never been a requirement that a converting institution demonstrate its need for capital before its conversion application is approved and we believe that the imposition of such a requirement would be inappropriate and detrimental to the industry. In general, we believe that (1) the OTS is without authority to impose qualification requirements on converting institutions, (2) the proposal overstates the pressure on converted institutions to achieve competitive returns on equity, (3) the proposal fails to acknowledge reasons for undertaking a mutual to stock conversion other than raising additional capital, and (4) the proposal's prohibitions on considering the effect of capital management tools, such as stock repurchase plans, in the institution's business plan are inconsistent with the goal of achieving satisfactory shareholder returns and the OTS' interim final rule that relaxes the limitations on post-conversion stock repurchases. Furthermore, we believe that the requirement to demonstrate an acceptable return on equity is not the appropriate measure for an acceptable business plan.

We are troubled by the lack of any empirical evidence to support this major policy shift. The proposal provides no analysis of how many recently converted thrifts have faced a hostile takeover or a proxy contest, which is the reason given for the return on equity requirement, or of how the proposal's business plan requirement would have an impact on the number of conversions conducted in recent years. We believe that a more rigorous analysis for both the need and the effect of the proposal is essential before the proposal can be implemented. We refer the OTS to the RP Financial Analysis, which we believe persuasively illustrates both the chilling effect of the proposal and the lack of need for it.

A. Qualification Requirements are of Not Supported by Governing Statutes and OTS Precedent

We believe that the qualification requirements of the proposal are not supported by the statutes governing conversions or by OTS precedent. Section 5(i)(1) of the Home Owners' Loan Act provides that any savings association that is, or is eligible to become, a member of a Federal home loan bank "may convert" from the mutual to the stock form. This provision gives mutual institutions the statutory right to convert to stock form if they choose to do so. In discussing the proposed regulations, senior officials of the OTS have been careful to state that under the proposed regulations the choice of converting to stock form will still be left to the institution. However, as explained in the RP Financial Analysis, the qualification requirements in the proposed regulations create a virtual moratorium on conversions by establishing a capital needs test and a return on equity requirement that can be met by only a handful of institutions. The true effect of this proposal would be to deny a savings institution the freedom to choose its form of charter.

Almost 30 years ago, the Federal Home Loan Bank Board faced a lawsuit from Prudential Federal Savings and Loan Association challenging the Bank Board's moratorium on conversions. Congress, aware of the lawsuit and the challenge to the Bank Board's authority to impose a moratorium, imposed a statutory moratorium (Public Law 93-100) that mooted the lawsuit. Notwithstanding the mooting of the question, the court stated in a subsequent order, "For a decade, *despite the clarity of [Section 5(i) of the HOLA]*, the Bank Board has apparently enforced a self-imposed moratorium on such conversions . . . (emphasis added)." Congress' actions and the court's comments reflect the likelihood of a finding that the administrative moratorium was without legal authority. The moratorium that would be created by the proposed regulations would also deprive mutual institutions of their statutory right to choose their form of corporate structure. Accordingly, these qualification requirements are contrary to and violate Section 5(i) of the HOLA.

Section 5(i)(2) of the HOLA authorizes the OTS to promulgate regulations for the conversion of savings associations from the mutual to the stock form. In 1974, when the original version of the current conversion regulations was adopted, the Federal Home Loan Bank Board recognized that the only limitation imposed by Section 5(i) of the HOLA was that a conversion be done on an equitable basis. Section 563b.3(a)(1), as originally adopted, provided that "[t]he regulations contained in this part are promulgated to provide rules by which mutual insured institutions may convert to the stock form of organization on an equitable basis." Over the years, the Bank Board and then the OTS modified the conversion regulations in order to fine tune the process. For example, amendments were made in 1982 to "allow converting insured institutions significant flexibility in structuring their conversions to meet particular marketing circumstances" and to "permit converting insured institutions to significantly reduce the expense and time required for conversion." 47 FR 19672. Amendments were made in 1994 that were "designed to strengthen the standards governing conversions and to ensure the integrity of the conversion process." 59 FR 61247.

The initial regulations and all of the subsequent amendments were developed in order to create and improve the process for converting from the mutual to the stock form. Along the way, the Bank Board and then the OTS have modified the process for conversion in order to balance concerns regarding the interests of members of mutual institutions, the interests of savings institutions in efficiently raising significant amounts of new capital, and the interests of the government, the public and the institutions in preventing the potential for abuses. The current proposal marks a significant departure from past policy. The proposed business plan requirements are not about process; they are about eligibility. For the first time, the OTS is seeking to specify by regulation which institutions are eligible to convert to stock form. In this regard, the current proposal is without precedent and without authority.

A requirement that an institution demonstrate a need for capital would be a throwback to the 1950s when financial institutions were required to justify the need for new branches or mergers and acquisitions. But even then, banks were not required to justify a need for additional capital. Moreover, it is difficult to reconcile the numerous legislative and regulatory initiatives over the last decade that have made capital levels the fulcrum of the regulatory process with the OTS' position in this proposal that substantial capital is adverse. We can only regard any policy that discourages insured financial institutions from raising capital as suspect. The capital that the thrift industry has accumulated over the last decade can easily be lost in poor economic conditions.

B. Protection from Hostile Shareholders Does Not Justify Qualification Requirements.

The rationale for the proposed business plan requirements hinges on the OTS' perception that many converted institutions have been pressured by hostile shareholders. We believe that the proposal exaggerates the extent of this problem. In our experience, only a small percentage of converted institutions have faced pressure from shareholders to either improve performance or sell. Accordingly, we disagree with the statement that institutions that fail to produce adequate returns on equity "will likely face pressure from dissatisfied shareholders." In those few situations where shareholder activists have pressured a recently converted institution, it is often the case that either the shareholder activist has exploited OTS rules or the OTS has failed to protect the institution by failing to enforce its current regulations evenhandedly. In some circumstances, management has done a poor job running the institution and the market responds by pressuring for a change. Having a business plan that projects a certain return on equity will not eliminate shareholder activists. Business plans do not satisfy shareholders, only performance does, and there are too many variables outside the control of management that will effect the ultimate outcome for the OTS to place so much reliance on a business plan.

It has always been an element of the conversion process, as with de novo institutions, that improvement in return on equity comes over time. To make sure investors understand this, converting institutions routinely disclose in their stock offering materials that the additional capital raised in the conversion will reduce the institution's return on equity and that it will take several years to achieve a return on equity comparable to that of more seasoned companies. As a result, investors should not have unreasonable expectations for what can be achieved.

Rather than restricting conversions, we believe that the OTS can do a great deal more to protect converted institutions from dissident shareholders without favoring the institution over the dissident shareholder or placing the dissident shareholder at a disadvantage. Regulations can be made to apply equally to the institution and dissident shareholders. For example, dissident shareholders have not been required to pay the same fees required of the institution for review of proxy materials and dissident shareholders have not been required to submit to the OTS in advance bylaw amendments that are inconsistent with regulations, notwithstanding the requirements applicable to federal associations in 12 CFR § 552.5(b). The OTS can more aggressively enforce applicable proxy regulations. For example, dissident shareholders have been permitted to include with their proxy materials correspondence from other dissident shareholders that includes statements that would not have been permitted in the body of the proxy statement. And finally, the OTS could more agressively enforce the regulations regarding acquisition of control of savings associations in 12 CFR Part 574. For example, dissident shareholders that together own more than 10% of a company's outstanding shares have cooperated in proxy contexts without being held subject to the notice or application requirements of the change in control regulations.

The OTS should also consider ways in which it can make the thrift charter more attractive and more conducive to producing greater shareholder returns. The business of mortgage lending has changed significantly in recent decades as competition and the secondary market for mortgages have significantly reduced the profitability of mortgage lending. In response, many savings associations have sought to diversify by becoming more complete financial service companies. This effort has been stymied in many cases by the non-mortgage lending limits applicable to federal thrifts, especially the commercial lending limit. The OTS should work with Congress to address this situation.

C. Need for Capital is Not a Proper Test.

(1) Other Reasons for Conversion Exist. The perception that most converted institutions face pressure to improve their returns on equity has caused the OTS to propose requiring that a converting institution demonstrate a reasonable need for new capital. However, important reasons for conversion exist other than raising additional capital. One reason shared by most converting institutions is the desire to provide stock-based compensation arrangements to employees. In the last decade, the percentage of Americans that have invested in the stock market has grown significantly and employees have grown much more aware of what it means to

have an ownership stake in their employer. During the same time, the use of stock-based compensation, particularly stock options, has also grown. This has become especially prominent among start-up business and the technology industry, which have used equity to attract the most talented employees. Many institutions believe that if they are to compete for employees, especially during present times when unemployment rates are at historic lows, that they need to be able to offer similar incentives. We believe that the OTS' emphasis on demonstrating a reasonable need for new capital ignores this important rationale for conversion.

Another reason that mutual institutions convert to the stock form is so they will have a currency other than cash (i.e., their own stock) with which they can acquire other financial institutions or businesses in the financial services industry. Since the success of any acquisition strategy depends on the ability to locate appropriate and willing targets and to negotiate a mutually acceptable price, and therefore is fairly speculative, it generally would not be appropriate to emphasize growth by acquisition in the institution's stock offering materials. It may also be difficult, or even inappropriate, to factor acquisitions into an institution's business plan projections, due to the many assumptions that would have to be made. Due to the fast pace at which acquisition transactions usually move and the competition for many target companies, in most cases it is impractical for an institution to first find an acquisition target and then convert to stock form. Too many other institutions would be able to complete the transaction more quickly and with fewer uncertainties. Accordingly, for an institution that intends to grow by acquisition, it makes more sense to convert first, and in doing so create a "war chest" for acquisitions, and then go out and try to find companies to buy. We are concerned that the proposed business plan requirements do not adequately recognize situations where growth by acquisition will play an important part in a converting institution's business strategy.

We also note that the mutual holding company structure is not as desirable a structure for pursuing an acquisition strategy. The OTS has approved only one acquisition by an MHC where stock was the form of consideration. Even assuming that the OTS will be willing to approve similar transactions in the future, in many situations it would not be possible for the converted institution to use stock as currency in a merger transaction and still have the MHC own a majority interest in the institution. This would be especially true for institutions that desire to make multiple acquisitions.

The future of the thrift industry is conversion to stock form to take advantage of financial modernization. Accordingly, we believe that instead of requiring demonstration of a reasonable need for new capital, the regulations should instead require the converting institution to establish a reasonable business purpose for adopting the stock form of organization.

(2) <u>Other Capital Raising Transactions Do Not Have Similar Requirements</u>. Savings institutions in stock form that raise additional capital through stock or debt offerings (whether through public or private offerings) are not required to demonstrate to the OTS a need for additional capital being raised in the offering. Furthermore, such institutions are not required

to demonstrate how the proceeds of any capital raising transaction will be used to serve the credit and lending needs of their communities. We do not see any need or reason to treat converting mutual institutions differently. The institution should decide whether it wants to undertake a conversion and raise additional capital and as to how it will utilize the additional capital. The OTS should not interfere with or second-guess that decision unless there is a safety and soundness issue raised by the activities or investments proposed to be made by the institution.

(3) There is No Evidence That Too Much Capital is a Problem. Although the proposal does not refer to it expressly, senior officials have referenced the 1994 FDIC study of the experience of converted New England savings banks. We question any reliance on conversions that occurred in the mid-1980s as a basis for concerns regarding overcapitalization today. It is widely recognized and acknowledged that there were many reasons for the failure of New England savings banks in the late 1980s. Overcapitalization due to conversion to stock form, was, if anything, a secondary reason. The primary cause of the problems in New England was a coincidence of time. At the same time that the laws changed to permit stock conversions of New England savings banks, New England was in the midst of a hyper-inflationary economy and a booming real estate market. Numerous thrifts converted during this period of time. Appraisals of these converting New England savings banks in the mid-1980s valued the converting institutions at three to four times net worth, making it almost impossible for these institutions to prudently deploy the excessive capital raised while subject to intense shareholder pressure to increase returns. Within a few years following these conversions, there was a significant decline in leading sectors of the New England economy and the New England real estate market crashed. At the same time, changes in tax laws elimated advantageous provisons for real estate investments. These factors resulted in the problems suffered by New England savings banks. It should also be noted that, during the same time period, numerous commercial banks, for which conversion is not an issue, suffered losses or failed in the New England region due to their involvement in real estate.

Another factor that differentiates the New England savings bank experience is the use of holding companies and capital management tools. In the mid-1980s holding companies were infrequently used and, therefore, converted institutions were unable to use stock repurchases to manage their capital. Instead, management was forced to achieve shareholder returns solely through earnings growth through non-diversified investments primarily tied to the New England real estate market. Ironically, the proposed business plan requirements will do the same thing.

(4) The Market Should Continue to Decide How Much Capital is Needed. The amount of stock sold by a converting thrift is based on a valuation of the institution by an independent appraiser. This valuation considers, among other things, the market for stocks of comparable companies. As a result of this valuation process, the market has a significant impact on how much capital a converting thrift raises. This is how it should be because it is the market that is buying the conversion stock.

The conversion market during the past decade, as illustrated in the RP Financial Analysis, provides an excellent example of how market forces have an impact on the results of conversion stock offerings. During the mid-1990s, conversions were popular with investors. The number of conversions and amount of proceeds raised were highest during these years. As a result of the popularity of conversions, the valuations of converting thrifts rose. Beginning in 1991, the average price/book ratio of converting thrifts rose every year until 1998, when it peaked at 76.2%. Beginning in 1997, however, investors became less interested in conversions. Significantly fewer transactions were completed in 1997 and 1998, and 1999 saw a significant bear market for conversions with only 12 conversions completed for OTS-regulated thrifts. During the last years of the 1990s and into 2000, in recognition of declining investor interest, the valuation of converting thrifts declined, reaching a price/book ratio of 52.7% in 2000. In a nutshell, valuations go up when thrift stocks are popular and, as a result, more capital will be raised. Conversely, valuations go down when thrift stocks are unpopular and, as a result, less capital will be raised.

A significant impact of the changing valuations in bull and bear markets is that when more capital is raised, the resulting return on equity is lower. And when less capital is raised, the resulting return on equity is higher. The OTS' proposed return on equity requirement would run counter to the market in that it would restrict access to the market when the market is at its most receptive. During bull markets for conversions, when valuations are higher and resulting ROEs are lower, the proposed return on equity requirement would impede the ability to complete a conversion. During bear markets for conversions, when valuations are lower and resulting ROEs are higher, more institutions may be able to meet the return on equity requirement, but weak market demand makes it more difficult to complete a stock offering. We believe that the OTS should not interfere with market forces and should continue to let the market play its role in determining how much capital a converting thrift should raise.

D. <u>The CRA Does Not Require that Conversion Proceeds be Used for Community Purposes</u>.

The proposal requires that the converting institution's business plan demonstrate that the institution's plan for deployment of the conversion proceeds will "substantially serve" to meet credit and lending needs of the institution's proposed market area. This appears to increase the obligation existing under the existing regulations, which require the business plan to demonstrate how the conversion will "help meet" credit and lending needs of the institution's community. We strongly believe that it would be inappropriate for the federal government to dictate what type of community activities an institutions should undertake or how much capital it must invest in the community. To do so would be inconsistent with existing CRA regulations. Moreover, it is not clear that the OTS has the authority to require that a converting institution use the conversion proceeds to make investments that the OTS believes would further the needs of the institution's community.

The CRA specifies what types of applications are subject to consideration of institution's CRA record. These are an application for (1) a charter; (2) deposit insurance in connection with a newly charted institution; (3) the establishment of a branch or deposit taking facility; (4) the relocation of a home office or branch; and (5) merger with a financial institution or aquisition of the assets or assumption of the liabilities of a financial institution. See 12 U.S.C. 2902(3). OTS regulations implementing the CRA provide that the OTS will take into account the record of performance under the CRA in considering an application for (1) the establishment of a branch or deposit taking facility; (2) the relocation of the main office or a branch; (3) the merger or consolidation or the acquisition of the assets or the assumption of liabilities of an insured depository institution; (4) a federal thrift charter; and (5) acquisitions subject to section 10(e) of the Home Owners' Loan Act. See 12 C.F.R. 563e.29. An application for a mutual to stock conversion is not among the listed applications in either the statute or the regulations.

Even if the regulations could be read to include an application for conversion, the proposal goes beyond what the CRA requires. The CRA requires merely that the appropriate regulator "take [the institution's record of meeting the credit needs of its entire community] into account in its evaluation of an application." 12 U.S.C. 2903. Similarly, Section 563e.29(a) requires the OTS to "take into account the record of performance under the CRA" when evaluating certain applications. The proposed regulation goes much beyond requiring that the OTS "take into account" the CRA record of the converting institution. It requires the specific use of the proceeds for CRA related activities.

As a practical matter, the requirement that the deployment of the proceeds substantially serves to meet the credit needs of the community is at odds with the goal of requiring a need for the proceeds. Why could an institution with a "satisfactory" or "outstanding" CRA rating not use the conversion proceeds to establish a trust department or to acquire an insurance agency? These activities would not appear to serve the credit and lending needs of the institution's market area, yet they certainly could be an important part of an institution's efforts to expand and improve profitability. Congress, through the passage of the Graham-Leach-Bliley Act and the creation of financial holding companies, has recognized the importance of diversification in the financial services industry and convergence of the various elements of this industry. The proposal is inconsistent with these dominant industry trends to the extent that it requires proceeds to be deployed in any particular fashion.

E. <u>Return on Investment is the Best Measure for Shareholder Satisfaction, Not Return on Equity</u>.

We believe that demonstrating a reasonable return on equity is not the correct measure for the business plan. While investors often focus on return on equity as a measure of a company's success relative to other companies, investors are ultimately more concerned with the return on their investment. The proposal's approach ignores the fact that investors may achieve adequate returns through a combination of regular cash dividends, share repurchases and growth in earnings per share and or book value, despite a below average return on equity. If the OTS is going to require that converting institutions demonstrate that they will satisfy investors, then the focus should be on shareholder returns and not on return on equity. And if shareholder return is the appropriate focus, then the OTS should permit converting institutions to assume a reasonable level of share price appreciation based on projections of book value and/or earnings per share growth. The OTS should also permit converting institutions to consider reasonable regular dividend payments and the effect of a reasonable level of stock repurchases because these are permissible actions that contribute to shareholder returns and are expected by shareholders.

We find it ironic that the OTS emphasizes return on equity in this proposed regulation while in its recently proposed regulation regarding notice of significant transactions by savings and loan holding companies (65 FR 64392) would establish 10% tangible capital, a level that effectively precludes achieving a superior return on equity, as the threshold for exemption from that proposed regulation's notice requirement.

F. Prohibition on Considering the Effect of Capital Management Tools Conflicts With Other Regulatory Initiatives.

We believe that it is inappropriate to not consider the effect of repurchases of stock in an institution's business plan. In revising the restrictions on stock repurchases, the OTS has acknowledged that stock repurchases after the first year should be a business decision of the institution. In recent years, stock repurchases have come to be viewed by many institutions and investors as a preferred alternative to cash dividends because repurchases do not result in ordinary income to all shareholders. If stock repurchases are an appropriate (and desirable) way for a company to manage its equity and are not prohibited to a converted institution during years two and three of its business plan, then the business plan should be entitled to assume a reasonable amount of stock repurchases during this period.

In our experience, strategic planning has received an increased emphasis in recent years by both recently and not so recently converted institutions. An essential part of this planning process is the development of a business plan. However, to be useful, a business plan must contain reasonable, well thought out assumptions. We believe that the business plan prepared in connection with a conversion application can and should serve as a real guide for an institution's first years following conversion and not just as an exercise in satisfying the conversion regulations. But in order for the business plan to an effective tool, it must not be subject to artificial constraints. Prohibiting the inclusion of capital management tools in the business plan that will be available to the converting institution during the business plan period will render the business plan useless.

G. Qualification Requirements Will Cause a Flight to State Charters.

Over the years, many states have adopted regulations that are similar to the OTS conversion regulations. The FDIC, in its administration of conversions of state chartered mutual institutions, has also looked to the OTS conversion regulations for guidance. With the implementation of this proposal, the OTS will create a significant difference between the regulatory regime for state and federal mutual institutions. The likely outcome will be that federally chartered mutual institutions that wish to convert to stock form will leave the federal system in order to do so.

H. Qualification Requirements will have a Disproportionate Impact on Small and Profitable Institutions.

The proposed business plan requirements would have the greatest impact on small mutual thrifts that are the OTS' core constituency. As the RP Financial Analysis shows, smaller thrifts (those with less than $100 million in assets) generally have equity as a higher percentage of assets, lower profitability and slower growth relative to larger thrifts. These smaller thrifts, which represent approximately 55% of OTS regulated mutual thrifts, would be least capable of satisfying the proposed return on equity requirement.

The proposed business plan requirements also would have the effect of penalizing mutual institutions that have had strong profits. Profitable institutions that have built up significant equity would be less able to satisfy the proposed return on equity requirement. As discussed above, this would unfairly disadvantage those profitable institutions that wish to convert for business reasons other than the need for additional capital.

3. Capital Distributions by Mutual Institutions.

The OTS has invited comment on whether to issue guidance or regulations regarding special capital distributions by mutual institutions. On a superficial level, a cash distribution by a mutual institution appears similar to a cash dividend by a stock institution and would provide a mutual institution with a mechanism to manage its capital levels. This would allow a mutual institution the opportunity to undertake a conversion without raising capital significantly in excess of its needs. This would also reduce the significance of post-conversion issues regarding stock repurchases and capital distributions.

However, despite the superficial appeal of cash distributions, we have both legal and practical concerns. In general, courts have been consistent in finding that the ownership interests of depositors is more theoretical than actual and is devoid of tangible value. The ownership interest of a depositor has been described as an inchoate property interest that vests upon liquidation of the institution. See Society for Savings in the City of Cleveland v. Bowers, 349 U.S. 143. We urge the OTS to consider whether by authorizing capital distributions by mutual institutions the OTS would be expanding the ownership rights of depositors by creating rights at a time earlier than liquidation and what impact that might have on depositors' rights in a conversion. From a practical standpoint, we are concerned about what expectations for a windfall distribution depositors might develop and whether the potential for capital distributions might lead to pressure by depositors for an institution to convert.

Years ago, the Federal Home Loan Bank Board determined that a method of conversion that provides a windfall distribution to the accountholders of a converting institution would create strong incentives for significant shifts of savings funds among insured instituions and that such shifts of savings funds would unacceptably threaten the financial stability of such institutions. The Bank Board also determined that any method of conversion that provides a windfall distribution would tend to force individual mutual institutions to convert to stock form irrespective of whether such institutions or the communities they serve would be benefited thereby. On February 28, 1974, the Bank Board made findings in adopting the initial form of the current conversion regulations. The third numbered finding concluded that the regulations being adopted were "designed virutually to eliminate the 'windfall' aspect of conversion and the resulting disruptive effect on the economy." 39 FR 9142. This principal was reiterated 20 years later in connection with the 1994 amendments to the conversion regulations. See 59 FR 22725. Regulations that permit a mutual institution to make a capital distribution as a precursor to a conversion would reintroduce a windfall element to the conversion process and with it, the possibility of the serious problems the OTS has so studiously avoided for over 25 years. Furthermore, when coupled with business plan requirements that contain a bias against highly capitalized institutions, regulations that permit capital distributions could become an even greater destabilizing force as they would create a perverse incentive to distribute capital.

To the extent that the OTS creates new rights and expectations on the part of depositors in mutual associations, we expect that this will attract mutual activists, which would be a whole new class of agitators to make the process more difficult. The insurance industry has experienced this phenomenon, as mutual insurance company policy holders have filed numerous class action suits challenging both MHC reorganizations and full demutualizations. Some of these suits, including those against National Life Insurance Company of Vermont Mutual and Old Guard Insurance Group, have raised claims that policyholders should have been compensated for their ownership interests.

Comments regarding specific sections

1. Section 563b.25. The definition of "person" should be revised to include a limited liability company. We recognize that the proposed definition is substantially identical to the definition in the current regulations and closely tracks the definition of person in Section 2(2) of the Securities Act of 1933, but we believe that expansion of the forms of business entities should be reflected in the regulations.

2. Section 563b.25. The definitions of "purchase" and "sale" are incomplete and not consistent with standard usage of those words. Generally, a purchase is an acquisition for value and a sale is a disposition for value. These concepts should be included in the definition. Compare the definition of "sale" in the current regulations, which say that "the terms 'sale' or 'sell' shall include every contract to sale" (emphasis added). The definition of sale in Section 2(3) of the Securities Act of 1933 uses substantially similar language. The definitions in the current conversion regulations and in Securities Act are expansive, while the proposed definitions are restrictive due to the deletion of the words "shall include". We suggest that the phrase "shall include" be reinserted in both definitions.

3. Section 563b.100(b). We believe that to the extent that this section requires a meeting with the OTS separate from the meeting to discuss the business plan required by Section 563b.100(a), that such meeting is unnecessary. Section 563b.8(t) of the current regulations provides that the OTS "will be available" for conferences to discuss the conversion. This approach is preferable since it does not a require a meeting when it would be of no benefit to the converting institution. Our experience has been that by the time an institution decides to convert, the senior officers and directors have become well versed in the issues relating to conversion through discussions with their peers and their many meetings with legal counsel, securities marketing firms and financial advisors. It is not necessary for the OTS to discuss what the institution must include in the application, as that information is set forth clearly in the conversion regulations. Neither is it necessary for the OTS to discuss general issues that an institution may confront in the conversion process. If, as suggested by the preamble, the board of directors is required to attend a meeting with the OTS, we believe this will add significant unnecessary expense. Although the second paragraph under Section II.A. of the preamble calls for a pre-filing meeting, we note that paragraph (b) of Section 100 does not specify that a meeting is required. Since paragraph (a) of this regulation uses the verb "meet" while paragraph (b) uses the verb "consult", the requirements of paragraph (b) are uncertain.

4. Section 563b.105(a)(1). The last sentence of this section states that the business plan must provide that the converted savings association must retain at least 50% of the gross conversion proceeds. Long-standing OTS policy has been to require that the converted institution retain at least 50% of the net conversion proceeds. We see no reason for changing this policy and suggest that this section be revised to conform to current policy.

5. Section 563b.150(a)(6). We suggest that since this requirement is stated in more detail in instruction B(7) to Form AC that it can be deleted here. As written, this regulation conflicts with instruction B(7) and overstates the situations in which a consent is required under current regulations and under the Securities Act of 1933. Section 150(a)(6) requires the consent of any professional who, among other things, "prepared" or "reviewed" any "statement" "for use." On the other hand, instruction B(7) requires a consent only if it is indicated in the application that a professional prepared, reviewed or passed on any part of the application.

6. Section 563b.240(f)(2). Current regulations require an opinion of counsel that the converting institution complied with all state laws applicable to the conversion. See 563b.8(c)(2)(ii). This requirement has been revised in the proposed regulations to include federal laws. Where a conversion is also governed by state law, we understand why the OTS would want an opinion from counsel regarding the converting institution's compliance with state law. In that circumstance, the OTS is not administering or enforcing state law and is not charged with knowing its requirements. By revising the regulation to add the requirement that counsel opine that the converting institution has complied with all federal laws applicable to the conversion significantly changes the nature of this opinion. The effect of this broadly phrased regulation is that the proposal asks legal counsel to be the guarantor of the conversion, which is widely considered to be an inappropriate use of a legal opinion (see the 1991 Legal Opinion Accord of the American Bar Association). As the OTS is aware, several different parties other than legal counsel assist a mutual institution with a conversion, the most significant of which is the marketing agent. Legal counsel has no control over how these parties fulfill their responsibilities. Furthermore, legal counsel is not closely involved in every aspect of the conversion. For example, once the stock offering commences, legal counsel's role is generally limited to responding to requests to assist the institution and the marketing agent in understanding the requirements of the plan of conversion, the conversion regulations and applicable securities laws. Counsel generally has little knowledge of the details of the conduct of the stock offering. If the OTS wants a certification regarding the conduct of the stock offering, that certification should come from the marketing agent. Accordingly, to the extent that the required legal opinion covers the conduct of the stock offering (which we think it would), we believe that the opinion requirement is unreasonably overbroad. We suggest that this section be revised to delete the words "federal or" from Section 240(f)(2), as is consistent with the current regulations.

Another problem with the opinion required by Section 240(f)(2) is the timing of the opinion in relation to the completion of the conversion. The opinion is required to be filed "promptly after the members' meeting." However, because the conversion has not been completed at the time the opinion must be rendered (in fact, the stock offering may still be underway), the proposal asks for a compliance opinion before the transaction has been completed. Any opinion regarding the conduct of the conversion should come after the conversion has been completed. The opinion required by Section 240 should relate only to the conduct of the members' meeting.

7. Section 563b.275(b)(3). The language "including any press releases, personal solicitation instructions, radio or television scripts that you plan to use or furnish to your members" should be moved to the end of Section 563b.150(a)(3)(iii), as this is the more appropriate place to identify the type of additional soliciting materials required to be filed. The language "and a legal opinion indicating that any marketing materials comply with all applicable securities laws" seems misplaced in this section as this section relates to filing additional proxy soliciting material and

not to marketing materials. Instead, this language should appear in 563b.150(a)(4), which should be revised to refer to the offering circular and any additional marketing materials.

8. Section 563b.335(b). We suggest that the words "or upon conclusion of the subscription offering" be added to the end of Section 563b.335(b). This would be consistent with subparagraph (d) of Section 563b.335, which implies that the institution need not conduct the community offering at the same time as the subscription offering. We suggest that the OTS clarify what is expected of converting institutions with respect to the offer of shares in a community offering. In recent transactions, the OTS has appeared to conclude that the converting institution must offer its shares locally in a community offering. We believe that this position is inconsistent with both the current and the proposed regulations. We note that Section 563b.335(b) says that the converting institutions "may" sell its shares in a community offering. We further note that Section 563b.395(b) begins "If you offer shares in a community offering..." (emphasis added), which also suggests that a community offering need not be held. Since only members of the converting institution are given the right to purchase stock in the conversion, we suggest that the OTS make clear that the converting institution need only offer shares in a community offering if necessary to sell the minimum number of shares required to be sold by the appraised value of the institution. To require a community offering in any other circumstance would be tantamount to providing persons unaffiliated with the institution with subscription rights.

9. Section 563b.345(a). This provision requires a converting institution to permit its depositors to use withdrawals from a deposit account or certificate of deposit to purchase shares in the conversion. Under current regulations, the institution has the option to permit the withdrawal of funds to purchase shares. We believe that although nearly all converting institutions permit the withdrawal of deposits to fund the purchase of shares in the conversion, that this should be left to the option of the institution.

10. Section 563b.380(c). The OTS should clarify whether a purchase by the ESOP under this provision is also subject to the provisions of Section 563b.510 regarding stock repurchases. We believe that the purchase of shares in the open market by the ESOP should not be considered a repurchase and that the restrictions on the repurchase of stock by converted institutions that are imposed in Section 563b.510 should not be applicable in this situation. Section 563b.510 refers to repurchases by converted savings associations. However, in this circumstance, the purchase would be conducted by the ESOP trust, which is a legal entity separate from the converted institution. The differences are significant. First, the legal consequences of a repurchase by the converted institution differ from a purchase by the ESOP. If the converted institution repurchases its stock, the repurchased shares are no longer considered to be outstanding. This means that those shares are not entitled to voting rights or dividends. Shares purchased by the ESOP, on the other hand, would continue to be outstanding shares and would retain all voting rights and the right to receive dividends. In other words, a repurchase by a converted institution is equivalent to retiring a portion of its shares, while the purchase by the ESOP is simply a

change in ownership of those shares. Second, a repurchase by the converting institution has a different impact on capital than a purchase by the ESOP. When the converting institution repurchases shares it is permanently returning capital to shareholders. However, when the ESOP purchases shares with a loan from the institution's holding company, the funds used by the ESOP do not permanently leave the converting institution as they must be repaid under the terms of the ESOP's loan. Thus, the reduction in capital caused by the ESOP purchase is only temporary until the loan is repaid. We note that the SEC treats benefit plans as separate from the issuer and exempts purchases by plans from certain restrictions when purchases are made by an agent independent of the issuer, such as an independent trustee. See 12 CFR § 242.102(c). We suggest that the new regulations specifically exempt repurchases approved pursuant to 563b.380(c) from the limitations imposed by 563b.510.

11. Section 563b.385(a). It appears that an error was made in re-writing this regulation. The second sentence says that "If you set a limit of five percent, you may provide that any person ... may purchase more than five percent..." (emphasis added). This sentence is internally inconsistent and departs from current regulation 563b.3(d)(4), which permits setting a maximum limit of 10%, but requires that the aggregate amount of orders that exceeds 5% shall not exceed 10% of the total offering of shares.

12. Section 563b.420(a). This first sentence should be revised to read as follows: "You must complete the conversion within 24 months of the date that your members approve the conversion." As written, it appears that only the selection of the closing date must occur during the 24 month time frame but that the actual completion need not.

13. Section 563b.500(a)(14). This section requires a certification that "the plan approved by the shareholders is the same plan that you filed with, and disclosed in, the proxy materials." We suggest that you add "distributed to shareholders in connection with the vote on the plan" to the end of this section. This will make clear that the regulations are not referring to the proxy materials relating to the approval of the conversion and will make Subsection (14) consistent with Subsection (8).

14. Section 563b.500(c). It appears that the incorrect word was used in the first part of this section. The regulation should say "[i]f your plan is amended more than one year following" and not "if your plan is adopted" (emphasis added). This correction is consistent with the intent expressed in the second to last paragraph under Section II.F. of the preamble.

15. Section 563b.505(d). We suggest that the period during which insiders may purchase shares only through a broker be reduced from three years to one year. We do not believe that the longer period of time significantly advances any policy and that it unnecessarily restricts insiders of smaller institutions. We understand that individual shareholders of smaller companies frequently contact the institution directly to see if anyone is interested in buying their shares. Prohibiting direct purchases by insiders for three years unnecessarily prevents these transactions.

16. Section 563b.510(a)(2). It appears that some words were inadvertently omitted when this regulation was revised. The phrase "pursuant to an offer" should be inserted after the phrase "OTS approved repurchase."

17. Section 563b.510(b). This provision permits stock repurchases after the first anniversary of the conversion, subject to all other applicable regulatory and supervisory restrictions. However, Section 563b.105(b) provides that an institution may not project stock repurchases in its business plan and Section 563b.115 provides that an institution must obtain the prior written approval of the Regional Director for any material deviations from its business plan. The effect of these three sections appears to be that, despite Section 510(b), an institution must obtain regulatory approval for stock repurchases during years two and three following conversion since stock repurchases would constitute a deviation from the business plan. We suggest that the regulations be revised to eliminate this result.

18. Section 575.8(b)(5). Although we welcome enhancements to the MHC form of organization that make it a more attractive alternative to full conversion, we do not believe that permitting subscribers to check a box on the order form to approve the institution's stock benefit plans will achieve this goal. As the preamble notes, Nasdaq and IRS rules require shareholder approval of certain plans. The approval of the plan by prospective purchasers who are not yet and may never be shareholders, will be insufficient for purposes of the Nasdaq and IRS requirements. As a result of these rules, we believe that companies will still need to obtain shareholder approval for these plans after the conversion. This, in effect, renders the subscribers' approval useless. Moreover, since grants must still be deferred for six months, the purchaser approval provisions will not materially enhance the ability of an MHC to implement a stock benefit plan. Accordingly, such plans should be implemented on the same basis as plans adopted by institutions undergoing a full conversion.

19. Form AC, Item 2. This item requires that the plan of conversion be distributed as an attachment to the proxy statement and the offering circular. It is unnecessary that the plan be attached to both documents. This would result in depositors receiving two copies of the plan of conversion. We believe that it is sufficient to attach the plan of conversion only to the proxy statement, as required by Item 16 of Form PS.

20. Form OC, Item 1. This item requires the offering circular to be dated as of the mailing date. We believe that this item should be revised to require the offering circular to be dated as of the effective date, which is consistent with current practice. See Rule 423 under the Securities Act of 1933, which provides that a prospectus used after the effective date of the registration statement shall be dated approximately as of such effective date.

21. Form OC, Item 1. This item permits the proxy statement to be attached to the offering circular. The staff of the Securities and Exchange Commission has expressly forbid this practice. Instead, the staff has required that the proxy statement and offering circular be separately bound.

The OTS' regulation should be consistent with SEC requirements and provide that the proxy statement may refer to information contained in the offering circular so long as the offering circular is delivered with the proxy statement.

22. Form OC, Item 3. The requirement to set forth the specified legend in capital letters is inconsistent with current practice of the Securities and Exchange Commission, which is to discourage text in all capital letters as it is difficult to read. We note that Item 501 of Regulation S-K no longer specifies type style or size for the legend required on the cover of a prospectus.

23. Form OF, Section 7. This section requires that the order form "include" a "separate one page certification." It is unclear how the order form can at the same time include a certification that is a separate page if separate is to mean unattached. Furthermore, this is inconsistent with common practice under the existing regulations, which is to include the certification on the reverse side of the order form. Requiring the certification to be on a separate (i.e., unattached) page will increase the likelihood that the certification will not be returned with the order form, thereby increasing the number of defective orders. It will also increase the number of items in the envelope to the member (which already includes numerous items), adding unnecessarily to the complexity and cost of the mailing. We suggest Section 7 be revised to require the certification to be included on the order form and that the certification have a separate signature block.

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Although most of the revisions to the conversion regulations have been identified as nonsubstantive, we believe, as indicated above, that there are several substantive changes in the regulations that have not been indicated as such. We urge you to review the revised regulations in light of the requirements of the Administrative Procedures Act and, if necessary, to consider re-proposing these regulations and highlighting all of the substantive changes in order to foreclose any challenges based on the procedure by which the regulations have been adopted.

We thank you for your consideration of these comments.

Sincerely,

Muldoon Murphy & Faucette

MULDOON, MURPHY & FAUCETTE LLP